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HANDLING COMMODITY FUTURES TRANSACTIONS

— by Neil E. Harl*

In the same manner as other merchants and manufacturers, farm and ranch taxpayers buy and sell commodity futures to hedge against fluctuating prices.¹ Likewise, farm and ranch taxpayers buy and sell commodity futures as speculators. The principal matter of concern from an income tax perspective in the farm and ranch area is the line between hedging and speculation.

Hedging transactions. Hedging is defined in terms of reducing the risk of price (or interest rate) fluctuations in the ordinary course of the taxpayer's business.² Hedging gains and losses generate ordinary income and loss and are not subject to the loss deferral rules and the "marked-to-market" provisions that are applicable to speculative transactions.³ Gains and losses that do not qualify as hedges and do not involve contracts primarily for sale to customers in the ordinary course of business are treated as capital gains and losses.⁴

The courts have emphasized two tests in evaluating commodity futures transactions as hedges or as speculative ventures — (1) the insurance test and (2) the direct relation test.

Insurance test. If a taxpayer uses futures trading to offset price changes in actual commodities (the "actuals"), the insurance test is met.⁵ Even if the taxpayer was not using futures trading to offset price movements in actuals, the U.S. Supreme Court has held that futures trading is hedging and not speculation if the commodity transactions are an integral part of the taxpayer's business.⁶ In *Corn Products Refining Co. v. United States*,⁷ the taxpayer purchased corn futures during harvest when prices were lower as a "pre-hedge" effort to guard against price increases. The court held that the transactions were not speculative dealings but were an integral part of its business and were designed to assure a ready supply of corn for manufacturing purposes while protecting itself against price increases. The court denied long-term capital gain treatment for profits from futures transactions (which is the proper treatment for speculative gains) and held that the gains were ordinary income.

The U.S. Supreme Court in *Arkansas Best Corp. v.*

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*Commissioner*⁸ limited *Corn Products Refining Co.*⁹ to its facts in allowing ordinary income from sales of commodity futures —

"*Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221."¹⁰

Recently, the courts have been asked to apply *Corn Products Refining Co.*¹¹ to post-harvest sales of crops and the purchase of like amounts of commodities in the futures market under the theory that the post-harvest position in the futures market was an integral part of the farming operation.¹² In *Nicholas C. Patterson*,¹³ the taxpayer, an Arkansas farmer, sold soybeans at harvest because of inadequate storage and bought soybean futures; the transactions were held to be speculative and not hedges on the grounds the taxpayer was not insuring against the risk of loss as to actual commodities. The argument that the *Corn Products Refining Co.*¹⁴ doctrine should apply was rejected.¹⁵ If the futures transaction is entered into after the actual commodity has been disposed of, there is no remaining risk of price change in the actual commodities, the insurance test is not met and gains and losses are capital gains and losses.¹⁶

Apparently, the Internal Revenue Service has taken the position that "fence" positions involving the purchase of puts and the sale of calls are not a hedge.¹⁷ Such arrangements involve establishing a minimum and maximum price for the commodity.

"Direct relation" test. Under the direct relation test, there must be a direct relation between the taxpayer's business and the commodity market transaction if the transaction is to be considered a hedge.¹⁸ Thus, the mere fact of purchase and sale of futures by a farmer producing the commodity involved does not assure that commodity futures transactions will be treated as hedges.¹⁹ Likewise, where the pattern of futures trading by a cattle feeder was three to five times the number of cattle on hand, the direct relation test was not met.²⁰ The amount of the position held and the pattern of trades must bear a reasonable relationship to the actuals held by the taxpayer.²¹ Thus, where the amount of futures trading exceeds substantially that needed to provide price protection for actual commodities or the pattern of purchases and sales in futures

is not consistent with securing price protection for the actuals, the transactions are likely to be treated as speculative rather than hedges with the result that gains and losses are capital gains and losses.²²

FOOTNOTES

- 1 See generally, 4 Harl, Agricultural Law § 27.03[8][d] (1991).
- 2 See I.R.C. § 1256(e)(2).
- 3 I.R.C. §§ 1092(e), 1256(e)(1).
- 4 McAdam v. Comm'r, T.C. Memo. 1991-410.
- 5 E.g., Stewart Silk Corp. v. Comm'r, 9 T.C. 174 (1947).
- 6 Corn Products Refining Co. v. U.S., 350 U.S. 46 (1955). See Crisp v. Comm'r, T.C. Memo. 1989-668 (futures transactions required as part of loan agreement were integral part of cattle raising business; gains were ordinary income). See also Myers v. Comm'r, T.C. Memo. 1986-518 (losses from sales of commodity futures contracts were capital losses where taxpayers failed to demonstrate that purchase of contracts was intended as hedge as to commodities purchased by taxpayer).
- 7 See note 6 *supra*.
- 8 485 U.S. 212 (1988).
- 9 See note 6 *supra*.
- 10 *Id.* at 1977. See also Heggstad v. Comm'r, 91 T.C. 778 (1988) (sale of Treasury bill futures contracts produced capital loss where contracts purchased by partner in brokerage firm as means of producing income to cover losses of partners' clients; contracts were investments even though business reason also involved). Compare

- The Circle K Corp. v. U.S., 91-1 U.S.T.C. ¶ 50,260 (Cls. Ct. 1991), *modified*, 91-2 U.S.T.C. ¶ 50,383 (Cls. Ct. 1991), *vacated*, 91-2 U.S.T.C. ¶ 50,382 (Cls. Ct. 1991) (ordinary loss treatment for loss on stock of company acquired to assure source of supply for retail operations; purchase characterized as integral part of company's inventory system and so excluded from definition of capital asset).
- 11 See note 6 *supra*.
 - 12 Patterson v. Comm'r, T.C. Memo. 1981-43, *aff'd in unpub. op.* (8th Cir. 1982).
 - 13 *Id.*
 - 14 Note 6 *supra*.
 - 15 See Commissioner v. Farmers Ginners Cotton Oil Co., 120 F.2d 772 (5th Cir. 1941); Trenton Cotton Oil Co. v. Comm'r, 147 F.2d 33 (6th Cir. 1945), *reh. denied*, 148 F.2d 208 (6th Cir. 1945).
 - 16 See I.R.C. § 1221.
 - 17 Abbott, "Is It Hedging?" *Farm Futures*, Sept. 1991, p. 22.
 - 18 See Commissioner v. Banfield, 122 F.2d 1017 (9th Cir. 1941).
 - 19 *Id.* See United States v. Rogers, 286 F.2d 277 (6th Cir. 1961) (futures trading did not relate to purchase and sale of livestock); Patton V. Richardson, Inc. v. Comm'r, T.C. Memo. 1981-288 (losses by cotton merchant in

- futures trading were speculative rather than hedging losses).
- 20 Lewis v. Comm'r, T.C. Memo. 1980-334.
 - 21 Hendrich v. Comm'r, T.C. Memo. 1980-322 (pattern of futures trading did not provide price protection for wheat held by taxpayer).
 - 22 See Est. of Laughlin v. Comm'r, T.C. Memo. 1971-52 (going "long" on soybeans did not provide price protection for soybeans to be produced); Oringderff v. Comm'r, 81-2 U.S.T.C. ¶ 9642 (10th Cir. 1981) (futures transactions on cattle held to be speculative for cattle feeder; many of transactions were opened and closed same day even though cattle on 120-150 day feed); Meade v. Comm'r, T.C. Memo. 1973-46 (pattern of transactions in corn and cattle futures did not provide price protection as to actuals). See also Oliver v. U.S., 83-1 U.S.T.C. ¶ 9356 (E.D. Ark. 1983) (farmer engaged in futures trading as speculative transaction and not as hedge); Vickers v. Comm'r, 80 T.C. 394 (1983) (speculative commodity futures transactions for farmer produced losses subject to capital loss limitation); *In re Blazek*, 90-2 U.S.T.C. ¶ 50,528 (Bankr. D. Kan. 1990) (taxpayer not precluded from attempting to prove trades were hedges even though majority were speculative).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

REPUDIATION. Two brothers, William and Walter, received an undivided interest in farm land from their father. The brothers partitioned the land into equal sized tracts. William's land had a fence running through it, dividing off 22.5 acres. Walter and his children used the 22.5 acres for various farming activities for more than 10 years. The lower appellate court held that although as between separate owners of the two tracts, the 22.5 acres would have belonged to Walter under adverse possession, because the

22.5 acres were transferred to William in the partition, Walter would be required to repudiate the transfer of the 22.5 acres before claiming title to the land by adverse possession. The Texas Supreme Court reversed, holding that because Walter did not possess the disputed land before the partitioning, repudiation was not required before adverse possession could commence. **Beard v. McLaren**, 811 S.W.2d 564 (Tex. 1991), *rev'g*, 798 S.W.2d 597 (Tex. Ct. App. 1990).

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